

Japan Wants a Weaker Yen—and Strong Banks

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WisdomTree Japan CEO Jesper Koll's Thoughts on the Upcoming BOJ Meeting Bank of Japan (BOJ) Governor Haruhiko Kuroda wasted no time to promote a weaker yen. As soon as Federal Reserve (Fed) chair Janet Yellen put the Fed's resolve to raise U.S. interest rates back on the table, Kuroda went out of his way to stress that the BOJ is ready to move the other way: "There is ample space for additional easing in each of the three dimensions, we will not hesitate to implement additional policy measures to achieve our target of pushing up inflation expectations".¹ In other words, the BOJ will not be passive and simply rely on a stronger U.S. dollar (via higher U.S. rates) but intends to actively promote a weaker yen by easing Japanese monetary policy. The timing and clarity of the comments are important, in our view. Globally, the drop in U.S. rate-hike expectations was one of the drivers behind the dollar's weakness. If indeed Yellen's speech signals a reversal of the Fed's likely rate path, the dollar should reverse as well. And domestically in Japan, uncertainty over future BOJ policy has been growing since the policy board announced a comprehensive review of monetary policy at its September board meeting. Now Kuroda's Jackson Hole comments should leave no doubt: the governor's confidence in the existing framework is unbroken and, yes, he is ready to ease again using the existing tools, i.e., the "three dimensions." **What to Expect – September 20–21** The BOJ's "three dimensions" of policy tools are: 1) quantitative easing, i.e., the growth target of the central bank's balance sheet 2) qualitative easing, i.e., the asset mix with which the quantitative target will be achieved (JGBs, REITs, ETFs, etc.) 3) Negative interest rate policy (NIRP), i.e., negative interest rates charged on specific types of bank reserves with the BOJ. In our view, added easing will likely come primarily through added quantitative easing, while quality and NIRP policies are expected to stay basically untouched. Specifically, we maintain our long-held view that the BOJ will commit to de facto financing the new fiscal expansion adopted by Japanese prime minister Shinzo Abe's cabinet in early August. Given that the extra budget borrowing requirement should come to about ¥5–10 trillion over the next 12–15 months, we expect the BOJ balance sheet growth target to rise from the current ¥80 trillion to ¥90 trillion. It is important to note that, technically, there will be one or two extra budgets, plus the main budget for FY2017 to make up the new fiscal expansion program; but the net new borrowing requirement over the treasury's original budget baseline should come to around ¥5–10 trillion over the next 12–15 months. Both ETF and REIT purchase targets will likely stay unchanged, in our view. Qualitative easing may also come into play, with municipal and local government bonds becoming eligible for BOJ buying. Against this, we do not expect the BOJ to "extend duration" of its bond-buying plans. In our view, a flatter yield curve is not a desired outcome at this point in the cycle because of the negative implications for margins for financial institutions in general, and banks in particular. **NIRP Stays Put** We do not expect

added cuts to NIRP, negative rates charged for certain bank reserve deposits, because of the asymmetric reward structure that added NIRP implies, in our view: a more negative NIRP would squeeze margins for financial institutions, while added benefits for the “real economy” are bound to be insignificant—the 10-year fixed mortgage rate is already at 0.6%.² If—counter to our expectations—the BOJ were to increase NIRP, it would send a very strong signal that the policy board wants to promote more aggressive and faster consolidation of Japan’s banking and financial system. We do not see this as a policy priority at this point in the cycle. **Investment Implications for Two Scenarios by Jeremy Schwartz, Director of Research, WisdomTree Asset Management**³: **Scenario 1: The BOJ will ease on September 21 and help promote a weaker yen—consider the [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#)** Actively promoting a weaker-yen policy at a time when U.S. dollar policy is ready for lift-off bodes well for the [WisdomTree Japan Hedged Equity Fund \(DXJ\)](#). No other fund does a better job of capturing the double gearing of a weaker yen compounding Japan’s earnings outlook, in our view. Remember: Every move of five yen against the dollar in yen weakness adds back about 6% to Japanese earnings.⁴ **Scenario 2: The BOJ will not cut NIRP and trigger the unlock of value in Japanese banks—consider the [WisdomTree Japan Hedged Financials Fund \(DXJF\)](#)** There is plenty of value in Japan’s financials: the “mega banks” trade on barely half their book value, close to the bottom of the historic 0.4x to 1.2x range.⁵ Part of this discount is forced by fears of an added “BOJ squeeze” through cuts in NIRP, in our view. If we are right and BOJ does not tinker with NIRP, Japan financials—and the [WisdomTree Japan Hedged Financials Fund \(DXJF\)](#) —are poised for outperformance, in our view. ¹Source: Bank of Japan, commentary at Jackson Hole, 8/27/16. ²Sources: WisdomTree, Bloomberg as of 8/26/16. ³Jeremy Schwartz is a registered representative of Foreside Fund Services, LLC. ⁴Source: Bloomberg. ⁵Sources: WisdomTree, Bloomberg as of 8/26/16.

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